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THE PICTURE: I'm going to start this Letter a little differently. I'm going to start it with a collection of my current notes and thoughts.

(1) On October 15 the Dow Theory signaled the existence of a primary bear market. This was followed on October 19 by the worst crash in the annals of Wall Street. "Black Monday" left Wall Street and Main Street in a state of shock. Nobody had ever seen anything like it. In ferocity it far exceeded any of the three major crash days of 1929 (i.e., October 28 down 12.8%, October 29 down 11.7%, and November 6 down 9.9%).

(2) Wall Street loves a bull market and hates a bear market. Wall Street loves a bull market because a bull market generates high volume and high volume in turn generates commissions. A bull market also spurs great interest on the part of the public in buying funds (more commissions). Thus, it is understandable that Wall Street's reaction to a new bear market usually entails an attitude of disbelief and denial. And in case you haven't noticed, that's exactly what we're seeing now.

(3) As I have stated repeatedly, the usual action following a crash (and remember, crash action is extremely rare) is for the price movement to retrace (in due time) roughly 50% of the ground lost during the crash. If the Dow were to make up 50% of the ground lost since the bear market began (the high was 2722.42), the Dow might recover to or around the 2230 level.

I have mentioned this 50% retracement theme repeatedly in these Letters, and I also discussed this phenomenon in two recent Barron's articles (articles of October 19 and 26). Other commentators have picked up this concept. Thus, there is now a widespread expectation that the Dow will recover to the 2200 area or beyond.

The stock market doesn't like its intentions to be advertised. Therefore, the Dow may recover to above the 2230 level -- or (and this is more likely) the Dow may fail to reach 2230. As I have so often written, the market hates to accommodate its players. Above all, the market hates to accomodate the gamblers (i.e, those on margin).

(4) If the bear market does continue an upward retracement of its crash path, I would guess that it will do so mainly via the blue-chips. I say this because the action of the advance-decline ratio, so far, has been distressingly sluggish on days when the Dow rallies. This can be seen in the surprisingly laggard performance of my proprietary indicator, DowPow (DowPow is the Dow adjusted for the action of the A-D ratio).

Therefore, in the event of a recovery by the Dow to 2230 or even above that level, I would expect the recovery to be disappointing to those who still hold a diversified portfolio of stocks. *The great majority of stocks have topped out, and are firmly in the grip of the bear.*

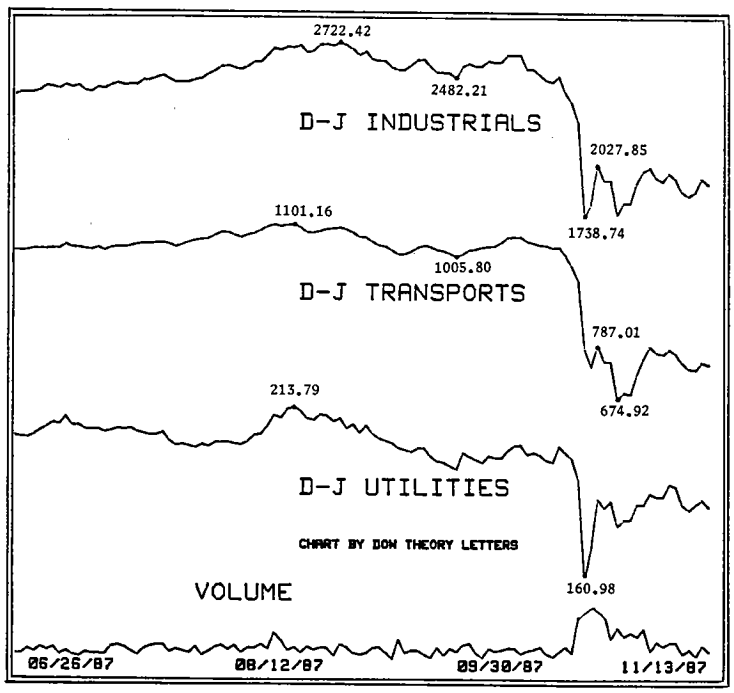
(5) The result of the topping out of the bull market in August and the crash action since would appear, on the face of it, to be deflationary. This can be seen in the drop in the CRB Commodities Futures Index, in the drop in crude oil below 19 dollars a barrel, in the collapse of the gold shares, in the weakness in gold, and in the extreme weakness in the other "precious metals." (I might add that in a bear market the non-gold precious metals such as platinum and silver suddenly transform themselves and become "industrial metals.") Deflationary expectations can also be seen in the recent explosive rally in bonds.

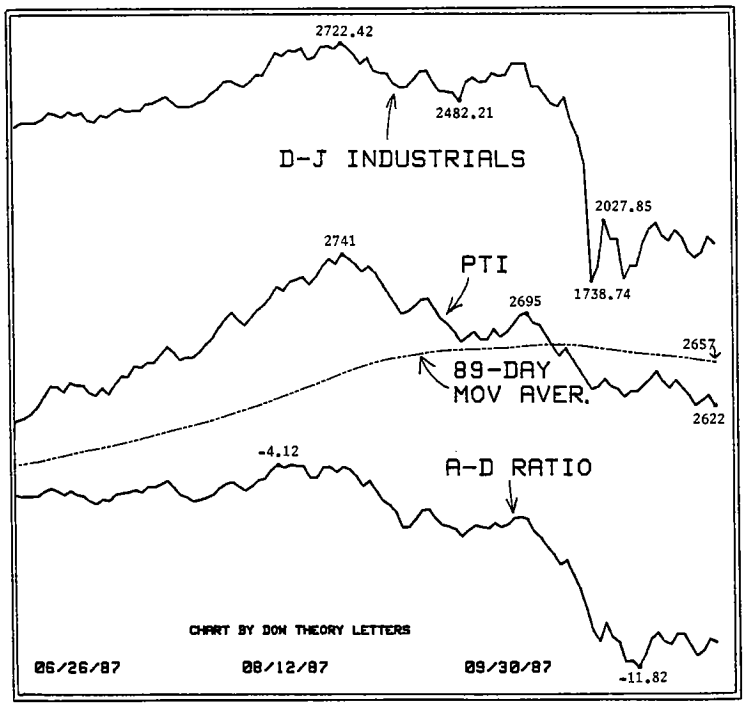
The reason bear markets are deflationary is that during bear markets billions of dollars of assets are lost -- they disappear into thin air. Already over a trillion dollars in values have been lost in the US markets via stocks, junk bonds, futures, options, mistaken speculative ventures -- and another trillion in values has been lost in the various overseas stock exchanges. These are values that have evaporated. They are gone (and I believe a decline in real estate values is just beginning). Thus, it is as if some of the floorboards have been pulled out from under the world price structure. This action is obviously deflationary.

(6) The authorities in the Free World have instantly recognized this deflationary phenomenon. And nowhere has it been more recognized (and FEARED) than in the US. The result has been that the US authorities have now embarked on a massive anti-inflation (i.e., re-inflation) campaign.

The Fed, having recently raised the discount rate, did a total flip-flop and opened the monetary floodgates. The Secretary of the Treasury (ironically, he's the official entrusted with guarding the US currency) has openly pressed for a lower dollar while at the same time he has pressured our creditors (Germany and Japan) to lower their interest rates and otherwise juice up their economies. These nations, in turn, have railed against the US for refusing to move toward a balanced budget. The international altercations, I suspect, are just beginning.

(7) The US authorities are aware that this nation is loaded with debt from sea to shining sea. They correctly see that a recession or





depression in the face of a debt-logged US would be an utter disaster. Therefore, they are making every effort to stave off recession. And (taking the easy way, as they alway do) they have chosen to do so at the expense of the dollar. The dollar has caved in during recent weeks.

(8) Normally, the weak dollar would result in a collapsing bond market. But the specter of an economic recession and deflation with accompanying lower interest rates has sent the bond market (at least initially) surging higher. The fact is that the bond market has been walking a tightrope -- it's been bolstered by the deflationary forces of the market crash on the one hand, and pressured by inflationary forces (set off by the Fed reliquefication program) on the other hand. So far, the bond market has chosen to react to the forces of rising liquidity and deflation. In short, the bond market has boomed. Whether this happy state of affairs can continue remains to be seen (if the increasing liquidity leads to visible inflation, then obviously the bonds will head down again).

(9) Everything in life (and in the markets) is a trade-off. There are no free lunches on Wall Street or any other street. The foreign markets are now suffering. "What America giveth, America taketh away." The crashing dollar is filling our foreign trading partners with fear and loathing. If their currencies continue to rise against the sinking dollar, their merchandise is going to be priced out of the market.

As foreigners see it, the falling dollar is causing their dream market, "the great American bazaar," to contract ominously. Already sales of high-priced items such as Mercedes and BMWs are slumping. Even Japanese cars are becoming high-priced items for Americans (for instance, the new two-door Acura Legend Coupe is priced at $29,000).

Foreign markets see the picture and they know what to do. They know exactly what to do -- they're heading down. Since October 16 the Tokyo (Nikkei) Average is down 14%, the Toronto (300) Average is down 17%, the Paris stock average is down 19%, the German (FAZ) Average is down 25%, the Sydney (all Ordinaries) Average is down 41%, and the Hong Kong (Heng Seng) Average is down 48%.

Consider this: The average Japanese stock sells at around 70 times earnings. Suddenly, Japan's biggest market, the US, can't afford "high-priced" Japanese goods. What could happen to Japanese stocks and the Japanese economy? Just a thought, just a thought.

(10) Meanwhile, our courageous politicians have been struggling to erase a mere $23 billion off the US federal budget. Their Herculean struggles are chronicled daily in the newspapers. Progress has been difficult, so difficult that it's even come to the point where President Reagan was pressured into joining the negotiations. In all, it's been an exercise in cowardice and political incompetence.

THE MARKET: In order to understand what is happening now in the market, it is necessary to understand what occurred during the crash of October 19. Here I want to interject a few very informative words from the latest report by my friend, Robert Prechter ("Elliott Wave Theorist," PO Box 1618, Gainesville, GA 30503).

"Momentum analysis was the one area that was flat-out bearish at the top. It has since provided two invaluable pieces of data. October 19, 1987, first of all, was the largest one-day percentage decline in the recorded history of the stock market. That is now common knowledge. What has not been recorded is that that day witnessed the most negative daily advance-decline ratio in the recorded history of the US stock market. For every stock up that day, 38 were down. A 1:4 ratio is normally considered a rout. Black Monday was ten times as bad."

All right, that gives you some idea of the downside compression that was created by the October 19 crash. It was an historic down-day. On October 19 we saw damage that any other primary bear market might have taken a year or two to produce.

The ferocity of October 19 created a technical vacuum on the upside and that vacuum was partly filled by the initial post-crash rally to the Dow 2027 level. From there the market settled back and simmered down. What happens next is beyond analysis, and fortunately, is not something we have to forecast. Maybe the most intelligent thing I can say here is that the bear will do whatever it has to -- to produce the most losses for the greatest number of people!

I do think we need to keep a totally open mind as to what to expect in the period ahead. We could get a bigger rally than the normal expectation (but from what level?). We could get a longer (in duration) rally than the normal expectation. Or we could get another swipe of the bear's paw and a testing of the Dow 1738 low (see Late Notes, page 6).

From here on we will be getting the usual batch of cocksure (and wrong) guesses from the same people who failed to see the bear market coming in the first place. That's to be expected. It's one of the peculiar (and ironic) hazards of this business.

In the end (I'll be saying this five dozen times before the bear market is over), it doesn't much matter to Dow Theorists how the bear market unwinds, how many rallies we see before the ultimate bottom or how sharp the decline prior to the bottom. We're not out to beat the bear, we're out to survive. And that means that we're on the sidelines -- getting liquid, paying off debts, building cash.

On one level, it might be stated that the "Art of Investing" entails (a) knowing what indicators and indices to throw out at any given time, and (b) knowing what gurus and experts to disbelieve at any given time.

I've often been asked why people are so reluctant to follow the Dow Theory, and more specifically why they are so reluctant to believe in the Dow Theory concept of a primary bull market or a primary bear market.

The reason why 95% of the public refuses to accept or follow the Dow Theory is its underlying thesis of **INEVITABILITY.** Man, little egotist that he is, insists on believing that he can control his own fate. But the Dow Theory tells us that once the great tide of the market turns up (or down), the tide will continue on to conclusion -- regardless of the wishes or actions of anyone.

People may be able to manipulate the manner in which the market goes up in a primary bull market or down in a primary bear

market. But they cannot change the ultimate result. That's what drives people (particularly politicians) crazy. And that's what costs them so much money and agony in the end.

Conclusion: The precepts of the Dow Theory got us out of this market at or near the highs. For those who chose to wait until the bitter end, the bear signal of October 15 provided the coup de grace, the final word. And the word was, "If you haven't believed it up to this point, the verdict is in, and you better get in harmony with it. The bear is now in command."

The Dow Theory has done its work. And we're simply watching the show. At this point my instinct says, "Let's not push it. We got out. The majority of stocks have been pulverized. We weren't holding any of those stocks. We're safe. Let's give ourselves a rest. We don't have to make brilliant decisions every day or every week or every month. Our current investment position (i.e., on the sidelines) is correct for a bear market. So let's let the fund managers, the in-and-out traders, the "perpetual optimists," and the bottom-pickers have their fun for a while.

A point to remember: 95% of the "experts," fund managers and advisories don't even know what a Dow Theory bear signal is, and obviously they missed the crash. It is human nature when you make a dreadful mistake to try to rationalize your mistake away. The obvious rationalization here is that "it's not really a bear market, and in due time the market will rally to new highs and bail us out." The unspoken implication is that "I didn't really mess up, it was just a stock market aberration, and everything will work out fine in the end." Russell comment: A bull market tends to bail you out of all your mistakes. Conversely, bear markets (and we're in one now) make you PAY for your mistakes.

Right now, as I see it, the stock market is still bloodied and licking its crash wounds. The market will stage a recovery in its own way in its own good time. The point to remember is that the ultimate upside correction (no matter how impressive) will only be temporary. In due time, the market will form what I term a "secondary top."

After that the bear will re-enter the picture. When bruin takes over again, this will represent the second phase of the bear market. The first phase of the bear market was the crash phase. *This is the phase when the market goes down "for no apparent reason" in the face of what appears to be favorable business conditions.* During the first phase the bear market simply eliminates the excitement and speculative froth of the preceding bull market top.

The second phase of the bear market sees stocks go down as *they reflect obviously deteriorating business conditions.* This phase may not appear until the first quarter of 1988 or even beyond. The longer this phase is held off, the more optimism will be generated on the part of Wall Street and the public -- and the worse the second phase of the bear market is fated to be.

The third phase of a bear market is the liquidation phase -- the "give up" phase. It is here that stocks are sold for no other reason but that cash must be raised. The third phase sees the final collapse of the blue -chip issues, as these stocks are the only ones with enough liquidity to be sold for hard cash. The third phase ends amid gloom and doom and statements such as "I don't want to ever hear about Wall Street, again." In the final throes of the third phase, good stocks will be liquidated at bargain prices with average yields on the Dow rising to probably 6.5% or better.

NEAR-TERM PRICE ACTION: In the last letter (Late Notes) I drew particular attention to two points on the D-J Averages, specifically, the 2027.85 peak for Industrials and the 787.01 peak for Transports (see page 1 chart). These were the peaks that we saw after the initial bounce from the crash lows (they were recorded on October 21). I stated that IF those two peaks were bettered, the odds were high that we could see a full retracement of the ground lost since the high or a Dow retracement to roughly the 2230 level. So far, the Averages have failed to better those peaks (see page 1 chart).

What have I noticed about the post-crash action so far? I guess the most interesting and probably significant phenomenon is the lack of breadth on days when the Dow rallies (see the lagging A-D ratio on the page 2 chart). This phenomenon also shows up with striking clarity on my own proprietary index, DowPow. In case you don't remember my previous explanations, DowPow depicts the action of the Dow adjusted for the action of the advance-decline ratio.

The horrendous collapse of DowPow is shown on the long-term chart (page 4). Here we see DowPow breaking back to levels not seen since 1982! That, perhaps more than anything else, demonstrates the awesome power of the October crash. What I believe DowPow is telling us is that as far as the average investor is concerned, the great mass of his stocks are in the loss column, and moreover -- this bear market is not going to let him come out anywhere near even.

The companion indicator, the Primary Trend Index (PTI) can be seen on the page 2 chart. My PTI (perhaps coincidentally) broke bearishly below its 89-day moving average on the day of the Dow Theory bear signal. From there, the PTI traced out a definite downtrend. November 10 saw the PTI sink to a new low. The market will be labeled bearish as long as the PTI continues in its current pattern (i.e., fluctuating below its 89-day moving average).

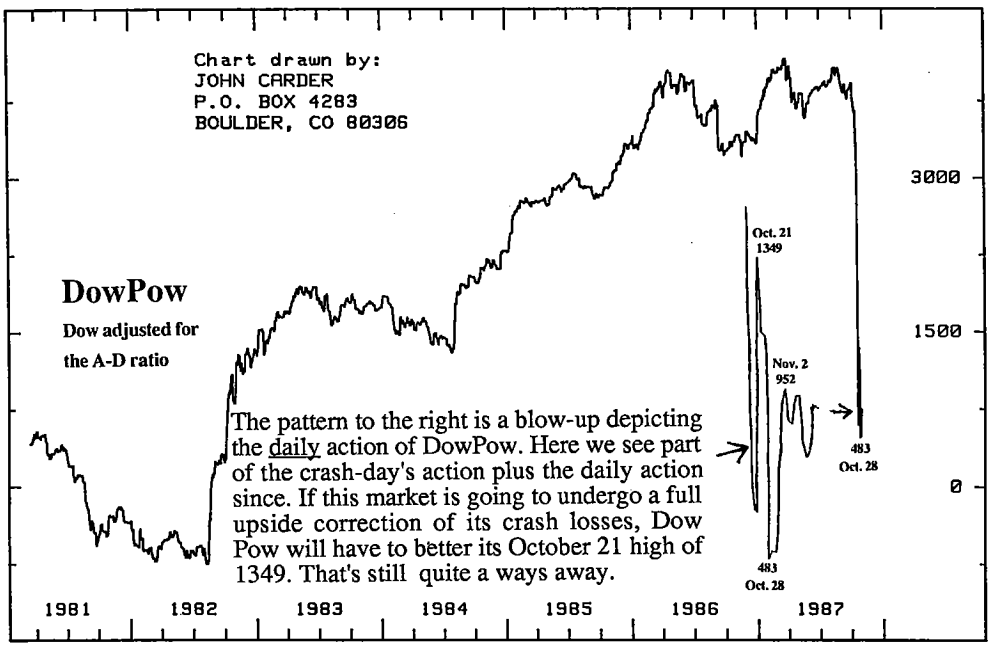
INVESTMENT POSITION: I hear a lot of talk about "this is going to be like 1962, so just sit tight and you'll get your money back." If that's what you want to believe, my advice to you is that you're wasting your time reading Dow Theory Letters. I was writing these reports in 1962, and the situation in 1987 is nothing like the situation 25 years ago.

At any rate, for those who take this report seriously, my guess is that the bear is going to be in this box for quite a while. You can also rest assured that we WILL be buying stock again one of these days. But when we do buy them we will be buying high-grade dividend-paying blue-chips at very attractive yields of 6% or better. Sound crazy? Just be patient.

The question arises: What do we do with our money now? The safest place to put it is probably in T-bills or in a money-market account or in a muni-cash (i.e., fixed dollar) account. I, personally, have also put money in high-grade muni bonds and I may be just greedy (trying to avoid taxes), but I'm going to take a chance with the bonds. I also continue to buy gold coins on a monthly-schedule basis.

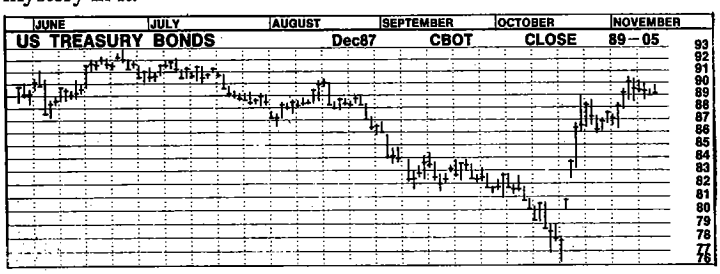
How about foreign currencies? Obviously, a great place to have had money was in German bonds or in Swiss francs or in yen. Too late to buy foreign currencies? The dollar (widely-advertised as a "doomed currency") is very over-sold now, and for the immediate future it may have fallen enough. There are two readily available ways to get into foreign currences. One is to simply buy a futures contract, but here you are on margin, and the shifts in currency prices might easily scare you out. Another way is one I have mentioned before -- buy International Cash Portfolios, a mutual fund. This fund holds seven different currencies, and you can move into any of the seven that you like. For those interested, I suggest writing for a prospectus at 251 S. Lake Ave., Suite 600, Pasadena, CA 91101.

BONDS, RATES: When the market crashed on October 19, perceptions changed. Suddenly, knowledgeable investors knew they were looking at potential recession and deflation, not boom and inflation. In the "new atmosphere," high-grade bonds at attractive yields were the place to be.



The pattern to the right is a blow-up depicting the daily action of DowPow. Here we see part of the crash-day's action plus the daily action since. If this market is going to undergo a full upside correction of its crash losses, Dow Pow will have to better its October 21 high of 1349. That's still quite a ways away.

The chart of the T-bond futures contract tells it all. In one of the most abrupt reversals you'll ever see, the bonds gapped up while interest rates sagged. That's the story in bonds -- there's no great mystery in it.



Question: I see that Nuveen has come out with a series of no-load municipal bond funds including a California and a New York fund. What do you think of these?

Answer: I have discussed the individual bonds vs. bond funds before, but here goes again. When you buy a bond you buy that bond in the knowledge that at a definite time in the future the bond will reach maturity. At maturity the bond will pay off at par (i.e., $1,000 per bond). If the bond is called before maturity, there is a definite schedule so you know when and at what price your bond may be called.

This same mechanism is also roughly true of unit trusts, which are simply collections of bonds pooled together in say a $50 or $100 million grouping. The collection is then sold in units of say $1,000 each. But the bonds in these unit trusts are not traded; consequently, there is an average maturity date on the trust. Thus if you hold the trust to maturity you will receive the maturity value of all the bonds in your unit.

This is NOT true of closed-end or no-load (open ended) bond funds. These funds are managed, and the bonds in the funds will be actively traded. Thus, there is no maturity date on the bond funds.

During a bond bear market or in the case of poor mangement, the assets of the closed-end and no-load bond funds will go down. In that case there is *no assurance that the investor will ever get his money back;* there is no maturity date on these funds.

For example, one of the oldest (if not the oldest) open-ended municipal bond fund is the Fidelity Municipal Bond Fund. I remember when this fund was selling above 14. The fund is now quoted around 7.50. You can wait from now until hell freezes over, and you may never see 14 on this fund again.

The next question is, "How do I buy bonds?" My suggestion is first, find a broker who specializes in bonds. The average broker is very much at sea when it comes to bonds. Then I suggest buying individual bonds of no less than A plus or AA ratings. It is often advantageous to buy discounted bonds (although the new tax discussions might change this). These are bonds that were issued years ago with lower coupons and are therefore selling at a discount below par because of current higher open market rates. These discounted bonds are much less likely to be called.

Conclusion: I have liked and continue to like high-grade individual bonds. I like high-grade muni bonds and I like T-bonds. It is said that stocks are good values when the earnings yield (earnings divided by price) on stocks equals the interest rate on good bonds. Currently, AAA-rated bonds provide better than 3% MORE YIELD than the earnings yield on the Dow.

PLEASE READ IT In the October Atlantic Monthly there appears an article ("The Morning After") by the brilliant Peter G. Peterson, former chairman of Lehman Bros. Kuhn Loeb and Secretary of Commerce under Nixon. When I say that this is the best piece I've seen on the economy in recent years, I'm not exaggerating. When I say this is MUST reading, I'm not exaggerating. This piece tells you why the bear market arrived and what the bear market is really all about.

I would like all my subscribers to have this 26 page article. I would like them all to read this article and study it carefully. After I read the Peterson article it took me three days to get over it. It's a mind-blower! It's also an education.

Here's an excerpt: "Far from forcing a 'revolution' in the role of the federal government, the 1980s have instead seen the federal budget become an even larger and more efficient consumption machine. By 1980 checks sent out automatically (to bond owners, health insurers, retirees, state and local benefit administrators) amounted to nearly 80% of all federal non-defense spending. We have now reached the point, in fact, where if we eliminated all discretionary non-defense spending (imagine that we could fire all civil-service employees and replace them with a giant check-writing machine), the federal budget would *still* be in deficit."

With the kind permission of Mr. Peterson and Atlantic Monthly I have reprinted the 26-page Atlantic article. I offer it in its entirety to my subscribers for a price of $7 (we pay the postage).

NOTES & QUOTES: If you like contrary opinion, here are a few choice items for you. According to an Adams and Reinheart Inc. survey, 87% of investors didn't sell any stocks or mutual funds during or after Black Monday, and 54% said they would consider buying stocks in the next six months. Of course, from a contrary opinion standpoint, that's hardly bullish. It merely means that these optimistic souls have been trapped by the bear.

Or maybe there's another reason why they didn't sell. They couldn't. The records show that in the two days following the crash, 90% of all phone calls to the no-load funds were greeted with busy signals. One large discount house which boasts around-the-clock service was putting out busy signals around the clock -- for 24 hours straight.

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More contrary opinion: The Fortune survey of 500 executives (Nov. 27 issue) shows the following results: 78% of the execs stated that they thought there would be no recession in 1987 or '88.

As for where the Dow would be one year from now, 53% thought the Dow would be above 2000, 7% thought it would be above 2500, only 1% thought the Dow would be below 1500! Amazingly, 82% of the execs thought their own company's earnings would be higher in '88 than '87. One thing is obvious -- the great majority of the executives interviewed are not taking the bear market seriously.

* *

Russell Fact: Think about this: The Dow dropped 36.1% between its August 1987 high and the October low. The Dow has never dropped this far without a subsequent recession -- never.

* *

Do you wonder why Wall Street is so focused on the dollar and what a falling dollar might do to our credit markets? Wonder no longer: The entire equity market (all stocks) in the US is valued at $1.2 trillion. This is dwarfed by the credit markets, which are valued at $4.2 trillion.

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Trade: Even with a much lower dollar the US will not find it easy to reverse its trade balance. For one thing, whole industries have disappeared in the US. Example, if you want to buy a VCR, you have to go foreign. We don't make them here. Second problem: Although the cheaper dollar has boosted foreign manufacturers' costs, they have elected to absorb half of those cost increases via reduced profits just to continue selling their products in the US.

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Frightening fact: Even if the US cuts its trade deficit in half by 1990, interest payments to foreigners will explode from $17 billion in 1987 to over $48 billion by 1990.

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Budget Cuts: The congressional committee is working on budget cuts and tax boosts. The tax increases will be instated -- count on it. But the budget cuts are another story. After the negotiations, any budget cuts will have to be made by the relevant congressional committees, not the negotiators. The WSJ is skeptical, and so am I. Asks the Journal, "So who is going to enforce this budget agreement? The fact remains that whatever real economic effects the deficit has, this summit is one more Reagan vs. the Democrats gladiatorial event that mainly titilates the town's political junkies. No one is talking about creating a mechanism to make fiscal prudence permanent. The budget summit is a unique, one-shot deal; after the '88 elections, most Members will be back at the watering hole." Russell comment -- Washington's attack on the deficit is both pathetic and ominous.

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Some of the biggest losses in the October crash do not appear in the lists of stock market losses. I'm talking about the hundreds of millions of dollars lost in options. For instance, many traders had sold naked puts. In other words, they had sold (not bought, sold) puts to traders who were speculating on the downside. When the market crashed, the put sellers' losses to the put buyers were astronomical. In some cases, the put sellers were bankrupted. In the case of Charles Schwab, a single customer's option trades cost Schwab a $15 million loss.

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Losses in many foreign markets were severe. The Mexican stock average lost over 50% of its value, Australian stocks lost 44% from their peak, London was down 33%, Hong Kong 44%, Singapore 48%, Tokyo only 17%. Many smaller Nasdaq stocks got badly hit. A survery of 250 Nasdaq stocks with values below $90 million lost 38% of their values.

* *

I got a lot of publicity due to my pre-crash bearishness and, of course, due to the October 19 Barron's piece. Frankly, I never like too much publicity, because (as you probably know) the history of widely-watched pundits in this business is dismal. Just about the time of your greatest fame, you blow it, and then you just fade away -- another headstone in the Wall Street Graveyard of forgotten Blooper-Makers.

But two write-ups particularly interested me. Mark Hulbert (with whom I have argued in the past) was kind enough to overlook my complaints and give me credit in the Nov. 16 issue of Forbes. Here's what he said:

By Mark Hulbert

Any investment letter that claims to have predicted Oct. 19's record 508-point drop in the DJI is lying. But some had their subscribers better situated than others.

Overall, the experience has reinforced my conviction that it makes most sense to follow the letters with proven long-term records. Of the six long-term Dow-beaters I discussed earlier this fall (FORBES, *Sept. 7*), no less than half held their own or better on Black Monday.

A few other letters did make notable calls. One, *Dow Theory Letters*, edited by Richard Russell, had come closer than probably any other adviser to catching the bottom of the 1973-74 bear market. So many astute investors took note when he downgraded his opinion of the market's primary trend from bullish to neutral in late August. Russell subsequently gave the parameters of an allout sell signal, which occurred on Thursday, Oct. 15, enabling close followers of Russell's letter to get out in time. Ironically, Russell had earlier mentioned 1500 as a possible bear market low—not too far off Black Monday's close.

And the Financial Post (the WSJ of Canada) went so far as to state that maybe I was instrumental in causing Black Monday. I thank the Post for giving me all that power, but honestly, I don't think I could set off a one-point rise in Chrysler, much less a crash on Wall Street. No, I wasn't the trigger, I was merely the messenger.

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I've been besieged over the past few weeks with Letters from subscribers asking every kind and variety of questions. I can't possibly answer all those individual questions, but I try to incorporate as many answers as possible in these reports.

I also received dozens of "thank-you" letters from subscribers who obviously took my warnings seriously and thereby avoided the crash. To all of you, a sincere "thanks" for taking the trouble to write. There's more to this business than making money.

VIEWPOINT

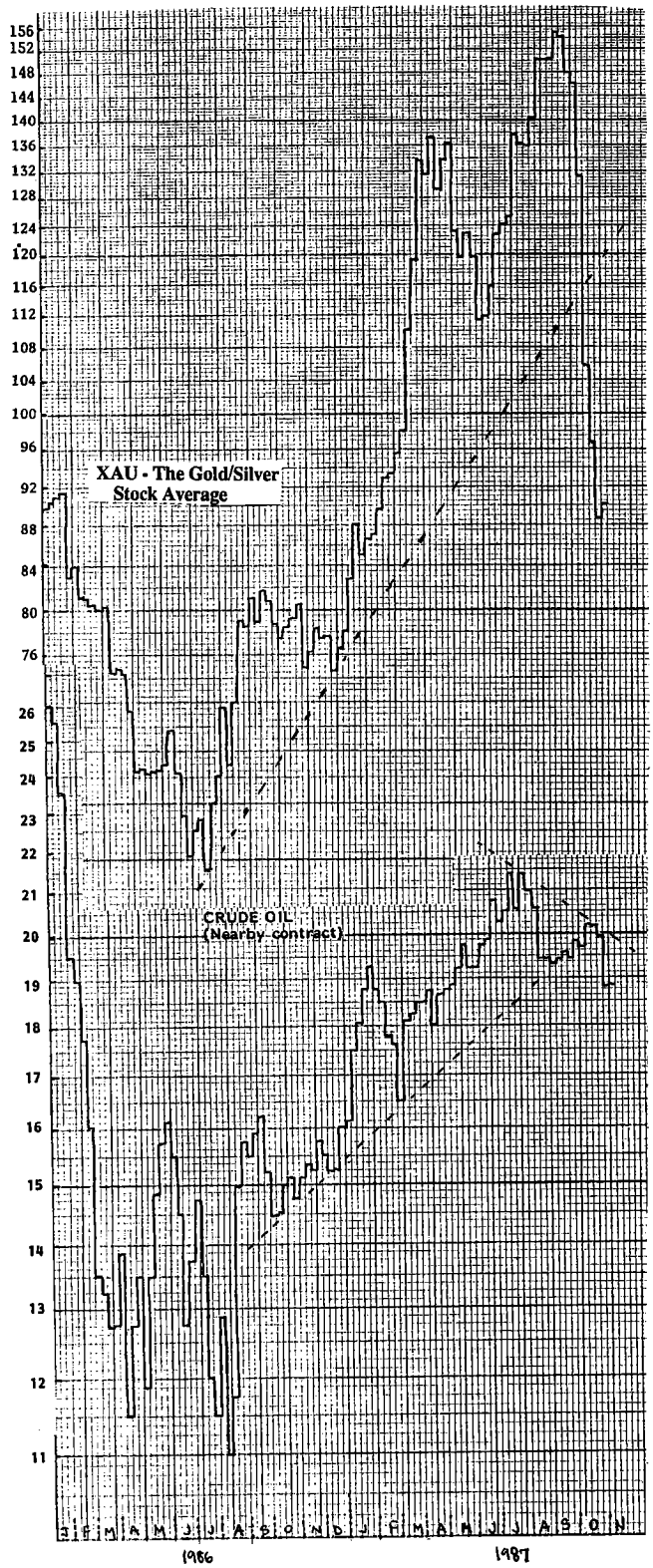
A major influence on the market on Monday, Oct. 19 — the day when Wall St. prices fell about 20% — was a brief article in Barron's magazine published over the preceding weekend.

The article was written by Richard Russell, of La Jolla, Calif., the acknowledged authority on the Dow Theory, author of the longest-lived stock market advisory service, and a person of formidable stock market judgment.

Russell's brief message: the decline in the Dow Jones industrial and transportation averages in early October had produced a "bear market" signal from the Dow Theory.

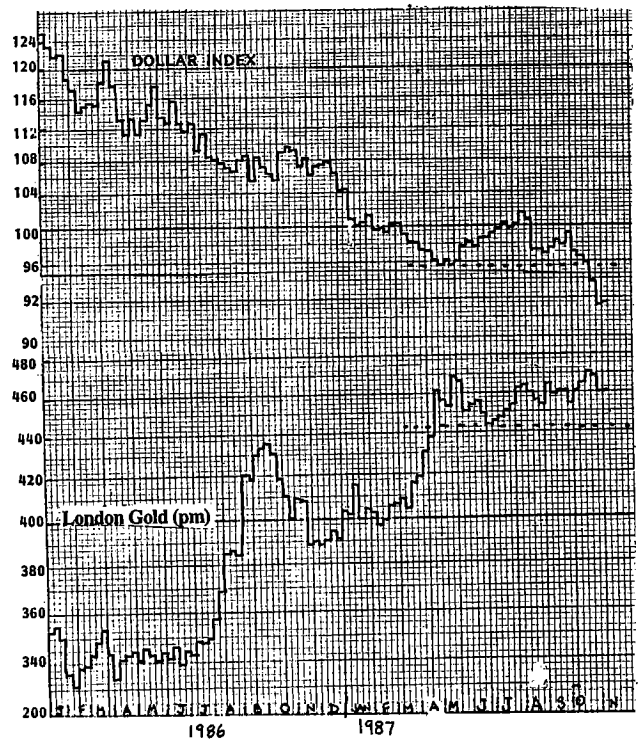
The Monday plunge was a bear market in itself. Nothing in recorded history equals the fall for speed and range. The South Sea bubble of 1720 may be the closest — an 80% drop in price in two months.

CHARTS: I show four important chart formations here, all scaled to the same semi-log proportions so that they may be accurately and properly compared. First is XAU, the gold/silver stock average, and here we see the big 1987 drop, a drop which cut XAU almost in half. Why did it happen? Gold stocks, good and



junky, were being sold willy-nilly, regardless of their earning ability and based on "the coming explosion in gold to 1000 or more." The only trouble is that gold never got above 500. Furthermore, with the dollar sliding steadily, gold didn't show any indications of "taking off into the wild blue yonder" as it should have. The gold stocks took the hint -- they swooned.

Meanwhile, as you can see on the chart, gold, the metal, has held pretty well, although it has gone sideways throughout most of 1987. There's strong support (the chart shows Friday closings) at roughly 440. If gold cannot hold 440 -- well, that would be my definite, all-out signal for deflation. Of course, bonds love the fact that gold is sluggish despite the dollar's collapse.



Crude oil broke below a one-year rising trendline in October. In doing so , it also broke to its lowest level since last May. To me that action contains intimations of deflation. The oil stocks act as if they believe it with Exxon cracking below 40 on Oct. 10.

Finally, we have the Dollar Index, which is an index of 11 currencies, heavily weighted for the mark and the yen. What can you say here? The dollar is doing what Treasury Secretary Baker (and evidently Mr. Reagan as well) want it to do -- namely probe the lower depths. The cheaper dollar is supposed to solve our balance of trade problem. If you believe that you also believe that the San Diego Chargers are going to be in the Super Bowl --- (naw, I can't use that phrase any longer, because, gad, can you believe it, San Diego leading the AFL West. The sports fans in this town are tip-toeing around here with stars in their eyes).

LATE NOTES: Since the October 19 crash lows, the Averages have formed large triangles. These are classic "indecision patterns." For the intermediate term, a Dow bettering of 2027.85 confirmed with a Transport bettering of 787.01 would imply that the triangles were reversal patterns, in which case we could see an important upside retracement -- recouping perhaps a third to one-half of the bear market losses.

Conversely, first indications of trouble would be the Dow breaking its November 10 low of 1878.15 confirmed with a Transport cracking of 734.29. A violation of those two points would strongly suggest that the Averages were heading back to test their crash lows.

Should the crash lows be broken, such action would suggest a severe recession to begin in 1988. As it is, I am of the opinion that we will see recessionary signs during this winter and spring.

This is an important concept: During a bear market values diminish through time. *Thus, the longer the stock market backs and fills in this area (with the Dow below 2027.85 and Transports below 787.01), the more likely that time is running out for a major rally or upside correction.* **In other words, time is your enemy when the primary trend of the market is down.**

Late Opinion: Washington's budget negotiations are turning out to be an exercise in impotency. It was a blatant demonstration of political cowardice and bodes ill for the future of the nation.

NEXT MAILING: Dec. 2